No. 15,888

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRANK W. BABCOCK, RESPONDENT

On Petition For Review of The Decision of The Tax Court of The United States

BRIEF FOR THE PETITIONER

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
ROBERT N. ANDERSON,
LOUISE FOSTER,
Attorneys,
Department of Justice,
Washington 25, D. C.

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BRIEF FOR THE PETITIONER

OPINION BELOW

The opinion of the Tax Court (R. 5-20) is reported at 28 T.C. 781.

JURISDICTION

The Commissioner determined a deficiency in the taxpayer's income tax for 1949 in the amount of $15,323.09 and an addition thereto under 1939 Code Section 293(a) in the amount of $992.38. (R. 6.) On January 18, 1955, which was within the ninety-day period allowed by the statute, the taxpayer filed a petition in the Tax Court for redetermination of

such deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 3.) After the hearing, the Tax Court decided on September 4, 1957, that there is a deficiency in income tax only in the amount of $4,161.77 for 1949, and also decided there should be additions to tax under Section 293(a) in the amount of $727.40. (R. 21.) Within three months thereafter, i.e., on November 25, 1957, a petition for review by this Court was filed by the Commissioner. (R. 37-39.) Jurisdiction of this Court is invoked under Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the taxpayer realized taxable gain under 1939 Code Section 112(f) to the extent of the difference between the total award paid upon the condemnation of the taxpayer's property and a smaller amount subsequently invested by the taxpayer in replacement property. This depends on whether the taxpayer, who was not personally liable on the mortgage covering the condemned property and who actually did not receive the amount used to pay off the mortgage must treat the whole amount of the award as the selling price, as the Commissioner determined; or is required to treat only the amount of his equity in the property as such price (which was less than the amount he reinvested), as the Tax Court held.

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory provisions and regulations appear in the Appendix A, *infra*.

STATEMENT

The facts so far as pertinent to the issue here were found by the Tax Court as follows (R. 7-9):

In October, 1945, the taxpayer purchased real estate known as the Elk Metropole Hotel in Los Angeles at a total cost of $89,600 and at the time of purchase he executed a promissory note secured by a mortgage, covering the land and building, in the amount of $70,000. On November 9, 1949, unpaid principal and interest on that note aggregated $57,572.63. Interest which had already been paid was claimed and allowed as a deduction on income tax returns filed during that period. (R. 7.)

On November 9, 1949, the State of California acquired the Elk Metropole Hotel under condemnation proceedings and pursuant to a formal contract with the taxpayer agreed that the selling price would be $207,323.34. At the same time and in accordance with the contract the State paid the mortgagee $57,572.63 (which was the balance due on the note) and paid the remainder of the selling price or $149,750.71, to the taxpayer. (R. 7-8.)

In March, 1950, the taxpayer made an informal application to establish a replacement fund and on July 7, 1950, while such application was still pending, the taxpayer purchased the Sherwood Apartment Hotel as a replacement of the Elk Metropole Hotel. The purchase price of the replacement property was $186,125 of which $149,750.71 was paid by taxpayer in cash from the money received from the State for the other hotel. (R. 8.)

In his notice of deficiency, the Commissioner held that since only $186,125 was spent by the taxpayer for similar property and $207,323.34 has been paid as the total condemnation award, the difference between these two figures should be treated as gain (i.e., long term capital gain); and so he increased the taxable income by one half of the resulting figure or by $10,599.17. (R. 8-9.)

The Tax Court refused to approve the Commissioner's determination, and held that no part of the condemnation award constituted a taxable gain. (R. 16.) Two other issues were decided for the Government and need not be considered here.

STATEMENT OF POINTS TO BE URGED

1. The Tax Court erred in holding that failure of the taxpayer to invest in similar property the amount of money retained by the State Government in condemnation proceedings and used to pay taxpayer's note secured by a mortgage against the condemned property did not justify recognition of gain to the taxpayer.

2. The Tax Court erred in failing to hold that there is a deficiency in income tax for the year 1949 in the amount of $15,323.09 and additions to tax under Section 293(a), Internal Revenue Code of 1939, in the amount of $992.38.

3. The Tax Court's opinion and decision are contrary to the law and Regulations pertinent thereto.

SUMMARY OF ARGUMENT

Taxpayer realized taxable gain upon the condemnation of his hotel by the State of California unless the

transaction falls within the non-recognition provisions of the statute, which require that all the money paid by the purchaser upon the conversion of the property into cash be used for acquiring suitable replacement property forthwith. Consequently, as the record shows that part of the award was not used in the acquisition of the replacement property, the statutory requirement has not been met and gain, to the extent of the money not so used, must be recognized for income tax purposes.

This view is in accord with the long standing Regulations which now have the force of law and which provide that the amount of the net award shall include any sum retained by the Government to satisfy any mortgages on the property even if the Government pays the mortgagee itself. These Regulations have been approved and followed in the applicable decisions of the Court of Appeals. But the Tax Court tried to avoid the implication of these decisions by holding here that the principle announced therein should be applied only in cases where the taxpayer has assumed the mortgage and can not be applied in this case because the taxpayer has no personal obligation for the mortgage debt under California law. There is no basis for such a distinction in the broad language of the statute and Regulations. Moreover when viewed from the practical standpoint, the economic effect upon the taxpayer's property is the same regardless of whether he has assumed the mortgage. It should also be noted that in either case, the taxpayer is entitled to use as a basis for depreciation the full amount of the property which means that he can include the

amount of the mortgage. Thus the Tax Court was in error in treating taxpayer's property as equalling only his equity therein. Such a definition of property has not only been repudiated in cases involving condemnation awards but also by the Supreme Court in *Crane* v. *Commissioner*, 331 U.S. 1, where it was held, in determining the amount of gain realized on an ordinary sale of mortgaged property, that the "property" was not to be diminished by the amount of an unassumed mortgage.

The Commissioner's determination is also supported by the Congressional Committee reports which discuss the statutory provision applicable here. In objecting to that determination, the taxpayer has relied primarily on a decision of this Court which involves depreciation claimed by a lessor on a building erected by the lessee under a 99 year lease. As this Court properly held, the taxpayer in that case had no wasting asset and could not show the required economic loss but in reaching its conclusion, this Court recognized that the facts there were distinguishable from those in the *Crane* case, and indicated that the term "property" may be given the definition for which we contend here.

ARGUMENT

The Tax Court Erred in Failing to Hold That The Taxpayer Realized Taxable Gain During The Taxable Year From The Condemnation Award

It is admitted that the Elk Metropole Hotel, which taxpayer purchased in 1945, was converted as a result of condemnation proceedings in 1949 into money in excess of his adjusted cost basis. Thus taxable gain

was necessarily realized by the taxpayer at that time unless the transaction falls within the non-recognition provisions of Section 112(f) of the Internal Revenue Code of 1939, Appendix A, *infra*, which are an exception to the general rule in providing that no gain shall be recognized if the condemned property is converted into money which is—

> forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, * * *. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

We submit that the purpose of Section 112(f) is to defer, not to exempt, gain realized involuntarily by such events as condemnation proceedings and then only when the indicated statutory requirements have been fully met, but as we shall show, the requirements have not been met in this case and the Tax Court's decision is wrong.

A. *The Tax Court's decision is contrary to the established administrative and judicial construction of Code Section 112(f)*

The record shows that under the condemnation proceedings, the State of California paid $207,323.34

for the taxpayer's hotel but in acquiring suitable replacement property (i.e., the Sherwood Apartment Hotel) the taxpayer spent only $186,125. (R. 7-8, 24-25.) Thus it follows, as the Commissioner determined, that since, in the language of Section 112(f), "part of the money" (i.e., the difference between the two amounts just referred to or $21,198.34) was "not so expended, the gain" (which is admitted to be $125,723.34 (R. 9)) "shall be recognized to the extent of the money * * * not so expended * * * ".

This is in accord with the long standing administrative construction of the statute embodied in Treasury Regulations. Section 29.112(f)-1 of Regulations 111 provides (Appendix A, *infra*):

> If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments * * *) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. * * *

These Regulations, promulgated under the specific statutory authority found in Section 112(f) have been in force for nearly 24 years [1] and are entitled, by

[1] The provision first appeared in Art. 112(f)-1, Treasury Regulations 86, promulgated under the Revenue Act of 1934. The Regulations were preceded by five years by a similar administrative interpretation by the Bureau of Internal Revenue. See G.C.M. 5302, VIII-1 Cum. Bull. 197 (1929), ruling that "money" received in payment for property taken by condemnation proceeding includes, under the antecedent of Section 112(f), in the Revenue Act of 1924, the amount deducted from the award to pay an indebtedness to the Government.

virtue of the successive reenactments of Section 112 (f) without change, to be regarded as law. Basically, the reason for this interpretation of the statute lies in the requirement that the money into which the property is converted be expended for the statutory purposes. Thus the Regulations also provide (Appendix A, *infra*):

> In order to avail himself of the benefits of section 112(f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. * * *

Obviously, where a portion of the money into which the property is converted is used to discharge a mortgage indebtedness on such property it is not used in the acquisition of other similar property.

The courts have expressly so held. *Commissioner* v. *Fortee*, 211 F. 2d 915 (C.A. 2d), certiorari denied, 348 U.S. 826; *Ovider Realty Co.* v. *Commissioner*, 193 F. 2d 266 (C.A. 4th); *Kennebec Box and Lumber Co.* v. *Commissioner*, 168 F. 2d 646 (C.A. 1st). The reasoning of the court in the *Kennebec* case applies directly to the facts here. The court said (p. 648):

> The payment, from the insurance proceeds, of the mortgage and the use of part of the fund for taxpayer's general business purposes can hardly

> be regarded as temporary investments of portions of this fund. These payments were not "investments" at all in any normal sense of that word; they were, on the contrary, final and irrevocable expenditures of this money for purposes utterly foreign to the acquisition of property similar to, or related in use to, the property destroyed.

The tracing provisions of the Regulations, which make explicit what is inherent in the language of the statute, have been sustained in numerous cases in addition to those cited above. See *Vim Securities Corp.* v. *Commissioner*, 130 F. 2d 106, 109 (C.A. 2d), certiorari denied, 317 U.S. 686; *Commissioner* v. *Flushingside Realty Co.*, 149 F. 2d 572 (C.A. 2d), certiorari denied, 326 U.S. 754; *Twinboro Corp.* v. *Commissioner*, 149 F. 2d 574 (C.A. 2d), certiorari denied, 326 U.S. 754; *Winter Realty & Const. Co.* v. *Commissioner*, 149 F. 2d 567 (C.A. 2d), certiorari denied, 326 U.S. 754.

Both the taxpayer and the Tax Court seek to avoid the implication of these decisions and the Regulations by suggesting that they apply properly only to mortgages which have been assumed by a taxpayer and are his personal obligation. But this distinction has no support in the broad language of the Code section or the Regulations nor can it be justified by the alleged practical difference between the taxpayer's personal obligation with respect to the mortgage debt in the one case and the mere economic burden on the property in the other. In both instances a condemnation award may be distributed partially in payment of the mortgage without regard to the taxpayer's wishes. In both cases the economic effect *upon the taxpayer's*

"property" is the same and the taxpayer realizes his admitted gain in the most concrete economic fashion, namely, by the conversion of his property into money. In neither is there any reason for postponement of the tax on such gain.

Moreover, even considered in purely practical terms, there is no significant difference. Normally, the same price is paid for property whether the mortgage is assumed or not, especially where, as in the instant case, the value of the property exceeds the amount of the mortgage. In both cases it will be the taxpayer who alone will gain by the increase in the market value of the property and its conversion into money. Furthermore, whether assumed by him or not, if he wishes to avoid foreclosure, the taxpayer must meet the periodic payments on the mortgage. Similarly in both cases, if the taxpayer wishes to rid his property of the burden of the mortgage or avoid sacrificing his property should the market fall, he must see to it that the mortgage is satisfied. An even more important consideration is that in either case the taxpayer, as we will develop in greater detail elsewhere in this brief, is entitled to depreciation on the full amount of his basis, which in each instance will include the value of the mortgage.[2]

The Tax Court's basic error stems from its analysis of the transaction here in such a way as to underestimate the amount of money for which the tax-

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[2] Here, the taxpayer in slightly fore than four years had already taken depreciation on the hotel in the amount of $8,000, as compared with his original cash investment of $19,600. (R. 9.)

payer's condemned property was converted. In other words, it was the Tax Court's position that the taxpayer's "property" was converted for the sum of $149,750.71 (i.e., the difference between the sales price and the amount due on the mortgage when the condemnation occurred.) Obviously this conclusion was based on the assumption that the term "property" as used in Section 112(f) means only the taxpayer's equity in the hotel, and that, as the Tax Court pointed out (R. 11), was also the basis for its decision (19 T.C. 99) in the case of *Fortee Properties*, *supra*, but it was overruled by the Second Circuit. Since the latter's opinion gives an excellent explanation of Section 112(f) and the facts there are very similar to those here, we take the liberty of quoting from it at length. The court there said (p. 916):

> The tacit assumption essential to the court's decision is that the word "property" in § 112(f) of the Internal Revenue Code means no more than the taxpayer's equitable interest in the land and the buildings. We disagree. In our view, the decision here should be governed by the rationale of *Crane* v. *Commissioner*, 331 U.S. 11, interpreting the meaning of "property" under § 113 of the Internal Revenue Code, 26 U.S.C.A. § 113. The *Crane* case involved the computation of tax gain on the sale of depreciable property subject to a non-assumed mortgage. The Supreme Court held the value of the mortgage must be included in determining the base and the amount realized on the sale. *The decision, distinguishing the words "property" and "equity", reasoned that "property" could not be restricted to mean merely the owner's rights over and above encumbrances.*

> While the *Crane* case can literally be distinguished as involving a different section and a different type of transaction, we think both the reasoning and spirit of the opinion are applicable here. The basis of the taxpayer's argument here is that, since he was not personally liable on the mortgage, he received no benefit and, hence, no gain on the satisfaction of the mortgage by payment to the mortgagee. This contention was rejected in the *Crane* case as to a transfer of property subject to a non-assumed mortgage. There the Court said that one "not personally liable on the debt, who sells the property subject to the mortgage and for an additional consideration, realizes benefit in the amount of the mortgage * * *." *Similarly, satisfaction of a non-assumed mortgage, by payment to the mortgagee, benefits taxpayer in the case at bar. In practical terms, for the purpose of protecting his property from foreclosure, where the value of the property is greater than the amount of the mortgage, the taxpayer-mortgagor has to treat the obligations of a non-assumed mortgage as if they were his personal obligations.* Payments to the mortgagee relieved the owner of this necessity. (Italics supplied.)

Crane v. *Commissioner*, 331 U.S. 1, to which the Second Circuit referred, required a determination of the gain "realized" under 1939 Code Section 111(a) and (b) (Appendix A, *infra*) from the "sale or other disposition of property" which the taxpayer inherited, subject to a mortgage. This, in turn, required a determination of the unadjusted basis of the property under Code Section 113(a)(5). (Appendix A, *infra.*) Both uses of the term "property," the Supreme Court

held, meant the owner's legal rights in the land and buildings sold, undiminished by the mortgage, and not the taxpayer's "equity" in them. Specifically the Supreme Court held (1) that the word "property" should be interpreted in its ordinary every day sense unless there are strong countervailing considerations which would support a different contention (331 U.S. p. 6); (2) that in other parts of the Code Congress has not confused the use of the words "property" and "equity" or made them interchangeable (p. 8); (3) that the word "property" should be construed so as to make such construction consistent with the depreciation and collateral basis adjustment sections (pp. 9-10) and (4) that in construing the "amount realized" and the word "property" it is immaterial whether the seller is or is not personally liable on the mortgage (p. 13).

Each of these considerations is pertinent to this case and the Tax Court's attempt to distinguish them falls far short of the mark. The word "property" in Section 112(f) was used in the same ordinary, everyday sense as was used in Sections 111 and 113. Here, just as in the *Crane* case, the functional relationship between Section 112(f) and the depreciation sections (1939 Code Sections 23(l) and (n) and 114(a)) provides additional support for our views. Under these sections, the basis for depreciation is the basis provided in Section 113(b) for the purpose of determining gain upon the sale of the property, which, in turn, is the Section 113(a) basis adjusted for depreciation. The *Crane* decision conclusively holds (1) that the unadjusted basis under Section 113(a) is the

cost[3] of the property *undiminished by the amount of a mortgage*, whether or not the mortgage is personally assumed by the owner of the property and (2) the depreciation allowance is computed on the full amount of this basis. (We do not believe this is open to argument or that the taxpayer will contest it. Indeed, as the record shows (R. 8-9) depreciation here was taken by the taxpayer in four years in the amount of $8,000 as compared with the taxpayer's original cash investment of $19,600.) Thus, for depreciation purposes and for the purpose of computing gain or loss on a sale, the mortgage will be included in the taxpayer's "basis" and in any "amount realized."

Since the Tax Court interprets the term "property" in Section 112(f) as including the mortgage in cases where the mortgage debt has been assumed by the taxpayer, it is difficult to see how it can insist that the term "property" be limited to "equity" where the mortgage has not been assumed. Indeed, it must be recognized that in this sense the Tax Court is reverting to its *Crane* decision (3 T.C. 585) which the Supreme Court ultimately rejected when it said (331 U.S., p. 14):

> * * * we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage

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[3] More accurately, since the *Crane* case involved property acquired by bequest, the holding therein was that the basis of such property was its fair market value (under Section 113(a)(5)) rather than cost. However, the *Crane* rule applies with equal force to purchased property. *Blackstone Theatre Co.* v. *Commissioner,* 12 T.C. 801.

> as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, *we are not more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.* If he transfer subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another. [Italics supplied.]

We submit that the logic of the observations just quoted demonstrates beyond question the lack of merit in the Tax Court's view that the only "property" of the taxpayer which was converted amounted to $149,750.71.

B. *The Legislative history of Section 112(f) supports the Commissioner's determination*

The Tax Court stated (R. 13) that, in deciding that no taxable gain had been realized as a result of the condemnation award, it had not overlooked statements made by the Congressional Committees in connection with Sections of the Act of October 31, 1951, c. 661, 65 Stat. 733, which amended Section 112(f)

prospectively. But we submit that the Tax Court failed to give full meaning to those reports inasmuch as they support our position here. In discussing the proposed changes in Section 112(f) both the House Ways and Means Committee and the Senate Finance Committee stated in identical language (H. Rep. No. 798, 82d Cong., 1st Sess., pp. 1-2; and S. Rep. No. 1052, 82d Cong., 1st Sess., pp. 1-2) that:

> While section 112(f) of the code now operates in the majority of cases to relieve taxpayers from the payment of tax upon gain where property has been involuntarily converted, the requirements of this provision have operated to deny relief in some cases where your committee believes that relief should be granted. No relief is accorded under existing law where, before receipt of the proceeds for the converted property, the taxpayer purchases replacement property. Relief is denied in these anticipatory replacement cases since the benefits of section 112(f) are limited to those cases in which the proceeds from the converted property can be directly traced into the subsequently acquired property. A problem also arises under the present law where the taxpayer uses a part of the proceeds from the converted property to pay off indebtedness on the converted property. In such a case the taxpayer is denied the benefits of section 112(f), *that is the taxpayer must pay a tax on any gain from the converted property up to the amount of the proceeds which are used in liquidation of indebtedness on the converted property, even though he also fully replaces the converted property, since the amount used to pay off the indebtedness cannot be directly traced into the replacement property.* (Italics supplied.)

From the above excerpt, it is evident that Congress did not draw any distinction between the payment of mortgage debts which have been assumed and those which have not been assumed by the taxpayer. Thus these Committee reports indicate that Congress intended to approve the Commissioner's interpretation of Section 112(f) and to make it applicable as to all transactions occurring before December 31, 1950. The Tax Court's reason for holding otherwise, as we have pointed out, was that the mortgage here had not been assumed by the taxpayer but as we have already shown under subheading A, *supra*, the fallacy in this approach we believe it unnecessary to discuss this point further.

However, it should be noted here that in support of its interpretation of the Congressional reports the Tax Court cited *Kennebec Box & Lumber Co.* v. *Commissioner*, *supra*, and *Ovider Realty Co.* v. *Commissioner*, *supra*. In neither of these cases was it stated, as the Tax Court did here, that a distinction should be made between mortgages which are assumed and those which are not assumed by the taxpayer. Indeed the opinions in those cases do not indicate specifically that the mortgages there had been assumed by the taxpayers. However, even if they are so construed, the principle announced therein was stated in such general language that it is clearly applicable here and does not support the Tax Court's decision. This is shown by the *Ovider Realty Co.* case in which the Fourth Circuit said (p. 269):

> And it has been held that the gain is taxable when, as in the pending case, the insurance

> money is used to pay a mortgage debt on the destroyed property or to pay a debt owing by the taxpayer to a bank, even though the destroyed property is subsequently restored and the taxpayer's financial ability to restore it is enhanced by the receipt of the proceeds of the insurance.

* * * *

Then, after citing most of the cases which we have cited herein, the Fourth Circuit pointed out that, "This line of authority" (p. 269) was recently recognized by the Congressional reports, which we have also referred to as supporting our contention here.

C. *The contention of the taxpayer is not supported by the decision of this Court on which he has relied*

In the Tax Court, the taxpayer relied primarily on *Commissioner* v. *Moore*, 207 F. 2d 265 (C.A. 9th), particularly this Court's statement where, in referring to the word "property" as used in 1939 Code Section 113(a)(5), it said (p. 268):

> But "such property" is not the steel frame, brick and terra cotta loft and store building on the corner of Figueroa, Seventh and Flower Streets in the City of Los Angeles,—it is the taxpayer's *interest* in that property. And her interest is a limited one, not only because it is a fractional part, but also because it is subject to the lease. As the Tax Court said, dealing with another point in this case: "What petitioner inherited from her mother was an undivided half interest in the land under the Barker Bros. building *and a reversionary interest in the building.*" (Italics supplied.)

Taxpayer has argued and doubtless will continue to argue that such statement indicates the correctness of his major contention, namely, that the several properties of the mortgagor (i.e., the taxpayer) and of the beneficiary or mortgagee were severally converted into money pursuant to the condemnation proceeding, and that the former received only $149,750.71 for his property and reinvested all of it.[4] We do not, of course, agree.

Obviously this Court's statement in the *Moore* case must be considered in the light of the question and facts involved there. In that case taxpayer and her mother owned land which they leased for 99 years to a company which agreed to erect a building thereon. When the mother died some years later, her interest in such property passed to the taxpayer who, in subsequent years, claimed that she was entitled to take deductions on account of depreciation attributable to a one half interest in the building (i.e., the interest inherited from her mother). These were allowed by the Tax Court but this Court reversed its decision. In doing so, this Court said that although taxpayer might have acquired a basis for depreciation under Section 113(a)(5), she did not inherit an interest in a wasting asset. In other words what she got was her mother's reversionary interest in a building which would have no value after 99 years, and her

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[4] Taxpayer has also argued that because of the effect of California law, this case is distinguishable from the *Fortee* case, *supra;* and the Tax Court also discussed California law. (R. 15-16.) But we think there is no material distinction in the two cases and that what we have said under subheading A answers this contention.

mother's interest in the ground rentals which would not be affected in any way by the deterioration of the building. But depreciation deductions were allowed to the lessee over the life of the building. In this connection this Court discussed *Crane* v. *Commissioner*, *supra*, which the Tax Court refused to follow here. It said (p. 272):

> The circumstances just mentioned disclose one reason why *Crane* v. *Commissioner*, 331 U.S. 1, * * * upon which taxpayer relies, does not support the Tax Court's decision on this point. There the Supreme Court held that one who inherited an apartment house worth $262,000, subject to a mortgage of $262,000, was chargeable with an amount of gain on resale which was arrived at on the assumption that the mortgagor could take depreciation on the value of the building, notwithstanding her equity was zero. *But there, as the Court was careful to point out, the mortgagor remained in possession, the mortgagee could not take depreciation, and unless the mortgagor could take it, the effect would be to "deny deductions altogether."* Here, to disregard taxpayer's limited interest, and permit her to take depreciation on the full value of the building, while lessee is properly claiming deductions based on the same values, would result in having deductions taken on the same building's depreciation twice. (Italics supplied.)

We submit that in making the above statement this Court was in effect announcing that a taxpayer who owns and is in possession of mortgaged property (regardless of whether he has assumed the mortgage) is to be treated as the owner of the entire property

and can deduct the entire amount allowable by statute for deterioration of the property rather than the portion which might be assigned to his equity therein. Thus it is evident that the *Moore* case does not attempt to limit the word "property" as the Tax Court has done in this case and does not preclude the adoption of the Commissioner's interpretation of Section 112(f). Moreover it did not involve a mortgage debt.

CONCLUSION

The decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
ROBERT N. ANDERSON,
LOUISE FOSTER,
Attorneys,

Department of Justice,
Washington 25, D. C.

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APPENDIX A

Internal Revenue Code of 1939:

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money received.

* * * *

(26 U.S.C. 1952 ed., Sec. 111.)

Sec. 112. Recognition of Gain or Loss.

* * * *

(f) [as amended by Sec. 151(d) and (e) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat of imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the ac-

quisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain shall be recognized, but loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain).

* * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.* — The basis of property shall be the cost of such property; except that—

* * * *

(5) *Property transmitted at death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent, the basis shall be the fair market value of such property at the time of such acquisition. * * *

* * * *

(9) *Involuntary Conversion.*—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion, described in section 112(f)(1) or (2), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable

to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.112(f)-1. *Reinvestment of Proceeds of Involuntary Conversion.*—Upon the involuntary conversion of property described in section 112 (f), no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 112(f), the gain, if any, is recognized to the extent of the money which is not so extended. * * *

* * * *

In order to avail himself of the benefits of section 112(f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property con-

verted. The benefits of section 112(f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

*   *   *   *

APPENDIX B

Table of Exhibits pursuant to Rule 18(2)(F) as amended.

Exhibits	Set forth in printed record	Identified, offered and received
4-D	R. 26 - 31	R. 23
5-E	R. 32 - 33	R. 24
6-F	R. 35	R. 24

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